

LETTER OF FINDINGS NUMBER: 07-0425

Income Tax
For Tax Years 2004-05

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ISSUES

I. Income Tax—Corporate.

Authority: *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992); *Indiana Department of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981); 15 U.S.C. § 381; IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; [45 IAC 3.1-1-9](#); [45 IAC 3.1-1-38](#).

Taxpayer protests the assessment of corporate income tax.

II. Tax Administration—Penalties.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a corporation doing business in Indiana and several other states. Taxpayer is the parent of a group of companies which collectively file an Indiana consolidated income tax return. As the result of an audit, the Indiana Department of Revenue ("Department") determined that one of the companies listed on the consolidated return ("Subsidiary") did not qualify for inclusion on a consolidated return, and removed that company from the consolidated return. The Department issued proposed assessments for income tax, penalties and interest for the tax years 2004 and 2005. Taxpayer protests these assessments on the basis that it believes Subsidiary, which was removed from the consolidated return, was eligible to be included. Further facts will be supplied as required.

I. Income Tax—Corporate.

DISCUSSION

Taxpayer protests the Department's determination that Subsidiary, listed on Taxpayer's consolidated returns, should not be included in those returns. Subsidiary had net operating losses which reduced the amount of tax due on the consolidated return. Also, the Department's removal of Subsidiary from the consolidated return resulted in higher apportionment factors for the remaining members of the consolidated return. As a result of the Department's removal of Subsidiary, Taxpayer was unable to claim the net operating losses, had a higher Indiana apportionment factor, and the Department determined that additional income tax was due. Taxpayer believes that Subsidiary is eligible for inclusion in the consolidated return. The Department notes that, under IC § 6-8.1-5-1(c), the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made.

The relevant statute for consolidated returns is IC § 6-3-4-14, which states:

(a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by [IC 6-3](#). The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.

(c) For purposes of [IC 6-3-1-3.5\(b\)](#), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.

(d) Any credit against the taxes imposed by [IC 6-3](#) which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

(*Emphasis added.*)

The Department determined that Subsidiary did not have adjusted gross income attributable to Indiana for

the years in question. Therefore, as explained by IC § 6-3-4-14(b), without adjusted gross income derived from sources within the State of Indiana, that company cannot be included in the affiliated group filing a consolidated return.

Taxpayer protests that Subsidiary should be included in the consolidated return, and that it did have adjusted gross income attributable to sources within the State of Indiana. The adjusted gross income tax is imposed under IC § 6-3-2-2, which states in relevant part:

a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

- (1) income from real or tangible personal property located in this state;
- (2) income from doing business in this state;
- (3) income from a trade or profession conducted in this state;
- (4) compensation for labor or services rendered within this state; and
- (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

....

Further, [45 IAC 3.1-1-38](#) provides:

For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

- (1) Maintenance of an office or other place of business in the state
- (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
- (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
- (4) Rendering services to customers in the state
- (5) Ownership, rental or operation of a business or of property (real or personal) in the state
- (6) Acceptance of orders in the state
- (7) *Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.*

As stated in Regulation 6-3-2-2(b)(010) [[45 IAC 3.1-1-37](#)], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of [IC 6-3-2-2\(b\)-\(n\)](#).

(*Emphasis added.*)

Of relevance here is 15 U.S.C. § 381 (Public Law 86-272), which prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales.

The Indiana Supreme Court explained in *Indiana Dept. of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981):

Public Law 86-272 (15 U.S.C.A. § 381), in pertinent part is as follows:

(a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

- (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
- (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

Id. at 1265.

The Court then explained:

We also believe that Congress perceived "solicitation" as embodying "sundry activities so long as those activities [are] closely related to the eventual sale of a product." Finally, when a corporate representative performs an "act of courtesy" in order to accommodate a customer, he has not ventured beyond the realm of "solicitation."

Id. at 1268.

The United States Supreme Court explained its standard for determining "solicitation of sales" in *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992). In *Wrigley*, the Court explained:

We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly *essential* to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are *entirely ancillary* to requests for purchases -- those that serve no independent business function apart from their connection to the soliciting of orders -- and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force. *National Tires, Inc. v. Lindley*, 68 Ohio App. 2d 71, 78-79 426 N.E.2d 793, 798 (1980) (company's activities went beyond solicitation to "functions more commonly related to maintaining an on-going business"). Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to *increase* purchases; but it is not ancillary to *requesting purchases*, and cannot be converted into "solicitation" by merely being assigned to salesmen. See, e. g., *Herff Jones Co. v. State Tax Comm'n*, 247 Ore. 404, 412, 430 P.2d 998, 1001-1002 (1967) (no § 381 immunity for sales representatives' collection activities).

Id. at 228-30.

The Court further explained:

By contrast, Wrigley's in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which Wrigley's regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [Wrigley's] credit department communicating." App. 71, 72. It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee -- some company ombudsman, so to speak -- if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases. Finally, Wrigley argues that the various nonimmune activities, considered singly or together, are *de minimis*. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007 [percent] of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was *de minimis* in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose, as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.

Id. at 234-5.

Therefore, the Department may look at a taxpayer's Indiana activities as a whole to determine if the activities as a whole exceed the protection of Public Law 86-272.

In the instant case, Taxpayer has provided documentation establishing that employees of Subsidiary performed activities which went beyond the protection of Public Law 86-272. As explained in *Wrigley*, a taxpayer's activities are examined as a whole and if a taxpayer has non-protected activities in a state which are not trivial, that taxpayer is not protected by Public Law 86-272. Here, Subsidiary had significant Indiana-based activities, including the assignment of several employees who were not engaged in sales-related activities. In 2004, Subsidiary had employees performing non-sales activities in Indiana for 27 days, as well as sales of products worth approximately \$16,000 to an Indiana customer. In 2005, Subsidiary had employees performing non-sales activities for 25 days. When reviewed as a whole, and considering that Subsidiary did conduct non-protected activities in Indiana, Subsidiary was subject to Indiana adjusted gross income tax, as provided by *Wrigley*.

In conclusion, the Department deconsolidated Subsidiary due to lack of Indiana-sourced adjusted gross income. Taxpayer has provided sufficient documentation to establish that Subsidiary did exceed the protection of Public Law 86-272, as provided by the Supreme Court in *Wrigley*. Therefore, Subsidiary did have Indiana-sourced adjusted gross income and was properly included in the consolidated return.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration—Penalties.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question. Also, Taxpayer protests the imposition of a penalty for underpayment of a quarterly estimated income tax payment for 2005. Taxpayer protests the imposition of penalties. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

[45 IAC 15-11-2\(c\)](#) provides in pertinent part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer did not incur deficiencies due to negligence under [45 IAC 15-11-2\(b\)](#), and so was not subject to penalties under IC § 6-8.1-10-2.1(a). Taxpayer has affirmatively established that there was no failure to pay any deficiency, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest is sustained.

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